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Rating Standards Should Give Less Weight to Default Issue, Analysts Say

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By Caitlin Devitt

CHICAGO - Amid a loss of confidence in bond insurers, public finance experts said yesterday that municipal rating standards should give less weight to the question of default and more to other underlying factors that determine credit strength or stress.

The comments come as all three rating agencies are reviewing standards and methodology for rating tax-exempt municipal debt. The reviews are due in part to pressure from regulators and state treasurers who have argued that municipal credits are generally underrated, as well as to rating agencies themselves, who have been "thinking about this for eight or nine years," said Donald Lipkin, managing director at Bank of America Securities, yesterday at the Information Management Networks Illinois Public Finance Conference held in Chicago.

Standard & Poor's efforts to review its rating standards has led to "hundreds if not thousands" of upgrades of municipal credits over the last few months, said analyst James Wiemken. "Our approach is to try to understand the drivers behind the strong credit quality."

Meanwhile, after months of soliciting comments from market participants, Moody's Investor's Service expects to soon announce possible changes in its rating scale policies, including whether the agency should expand its current so-called global ratings system to include tax-exempt municipal debt. Under its current system, Moody's provides both municipal ratings and global ratings on taxable municipal debt if the issuer requests it. So far 27 issuers have requested the action, said Moody's analyst Ted Damutz.

Fitch Ratings also recently announced it was beginning to review its ratings process.

"This exercise shouldn't solely be based on default, but on many factors," said Phillip McKenna, director of the Midwestern zone for the National Association of Independent Financial Advisors. "We need to get out of the context of default. If ratings are based solely on default, then we should all be double- or triple-A, but that's not where your ratings are coming from. Now insurance means absolutely nothing - so the importance of differentiating [underlying credit factors] becomes ultimately more important to issuers."

Between 1970 and 2000, only 19 of 28,000 of municipal issuers defaulted, said Damutz. And between 1986 and 2006, 34 of Standard & Poor's-rated issuers defaulted, according to Wiemken. When default does occur, it's the result of several factors, the analyst said - and it's those factors that are most important to investors.

In reviewing its credits, the agency has started to give more weight to the issue of management and its role in shaping how a government addresses risk, Wiemken said. Standard & Poor's is also "backing off" previous assumptions that smaller, often rural credits were riskier credits in their lack of economic diversity, he said.

Beyond general obligation debt, the agency is also reviewing several other debt sectors, said Wiemken. For example, when considering water and sewer debt, the agency is looking at how that type of debt is generally more resistant to economic declines and politics than other types of debt.

Reviews of public and elementary school districts now increasingly consider the role the state plays in the district's finances. And analysts are reviewing ratings on a number of special districts, such as park and fire districts, in light of fiscal flexibility of those districts, Wiemken said.

The shift in criteria has, in many ways, led to the rapid series of upgrades from the agency over the last several months.

"We've come to the conclusion that even in difficult economic times like these, governments are pretty well poised to make it through this downturn and meet challenges in the future," Wiemken said.